

**Statement of Mark Kiefer
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Before the House Aviation Subcommittee of the
Committee on Transportation and Infrastructure**

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Introduction

Mr. Chairman, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss this very important subject. My name is Mark Kiefer, and I am an aviation industry analyst for CRA International, a global economics and management consulting firm. In my remarks I will speak directly to each of the issues that have brought us all here today. Specifically, I will provide an assessment of the current situation now facing the US commercial airline industry, provide comments on the likely impacts of the recent bankruptcies of Delta Air Lines and Northwest Airlines and the current high fuel prices, and offer my views on the outlook for the future of the industry.

The Current Situation

It is not an exaggeration to say that the US commercial airline industry is now facing the greatest crisis in its nearly 100 year history. The statistics that describe this crisis are staggering. Since 2000, US airlines have collectively sustained net losses of over \$32 billion, a figure that will likely rise to \$40 billion by the end of this year. These companies are all publicly traded corporations. The steep declines in their stock prices have wiped out over \$24 billion in market value, an impact felt directly by the millions of Americans who are their shareholders. These losses have clearly taken their toll, as five of the ten largest US airlines have filed for bankruptcy protection in the last four years.

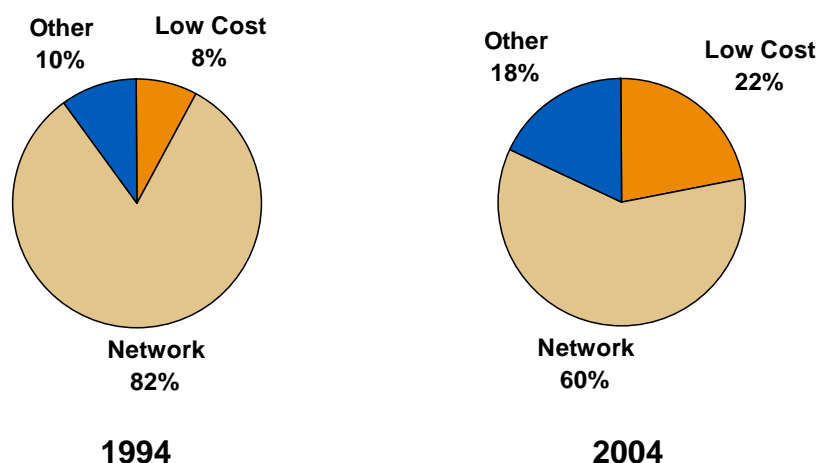
These airlines are also significant employers, both in the cities in which they are headquartered and in the many cities throughout the country that they serve. Well over 100,000 Americans employed in the industry have either been furloughed indefinitely or lost their jobs entirely, and both Delta and Northwest have recently announced that additional job losses are likely. Wages and benefits have been cut substantially, and this trend is likely to continue. Two of the largest US airlines have terminated their pension plans, resulting in the largest pension default in US history. Those airlines that continue to provide these benefits face unfunded pension liabilities of nearly \$14 billion.

The effect of this crisis is also being felt in many other sectors of the economy. Aircraft financiers are having to renegotiate less favorable terms as the airlines struggle to make interest and lease payments. Aircraft manufacturers and their suppliers likewise face the prospect of delayed, cancelled, or foregone orders as airlines are unable to afford new equipment. And the Federal Aviation Administration faces a potential funding shortfall due to significantly reduced ticket tax revenues.

This crisis has resulted from a number of factors. Even before the events of September 11, 2001, a softening economy had begun to significantly weaken the demand for air travel. At that same time, business travelers had begun to balk at the high prices being charged for unrestricted tickets, and had begun to seek lower cost alternatives, if not forgo their travel altogether. After September 11, air travel declined markedly, and this decline was disproportionately made up of business travelers. The industry has since been buffeted by the additional challenges of SARS and the war in Iraq, and oil prices have risen dramatically, reaching an all time high in nominal terms in the last month. While air travel has returned to pre-9/11 levels, the number of business travelers willing or able to pay high fares has not.

The increasing availability of online travel services has created unprecedented price transparency, such that business travelers now have far easier access to the lowest fares available. And today low fares are not the exception but the rule. Low Cost Carriers (or LCCs) having grown significantly in recent years, now constituting nearly one fourth of the US market, up from only 8% ten years ago.

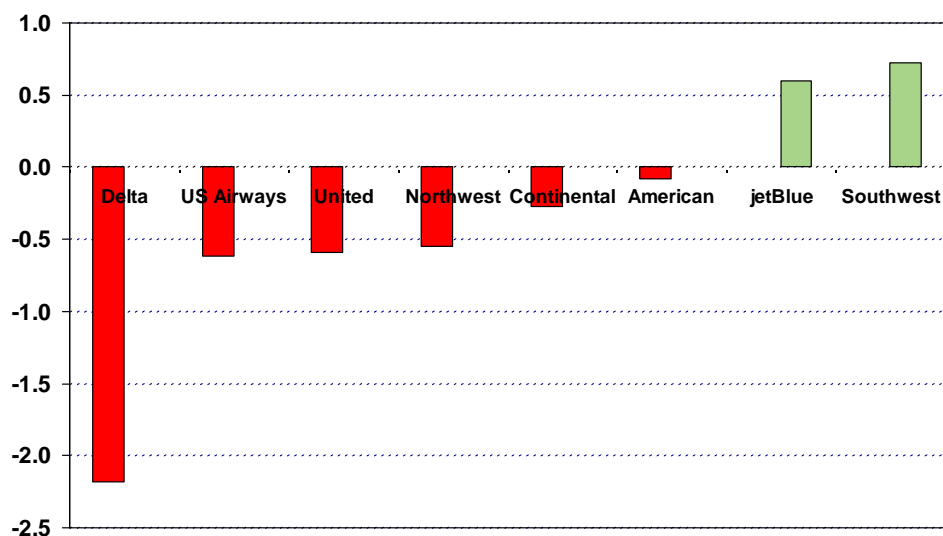
Airline Market Share by Category



Source: US DOT Form 41, Schedule T-3.

jetBlue and AirTran have both surpassed \$1 billion in annual revenue, such that they are now classified as major carriers by the US Department of Transportation. Southwest Airlines is now the largest domestic airline in the US. Most cities served by the legacy carriers are now served by at least one LCC, and legacy carriers face LCC competition in most city pair markets. This high level of market penetration has allowed the LCCs to dictate price. Because the legacy carriers still have higher operating costs, they can't make money at these low prices.

**Operating Margin for Selected US Airlines (cents/available seat mile)
Year Ending 12/31/04**



Source: Airline annual reports.

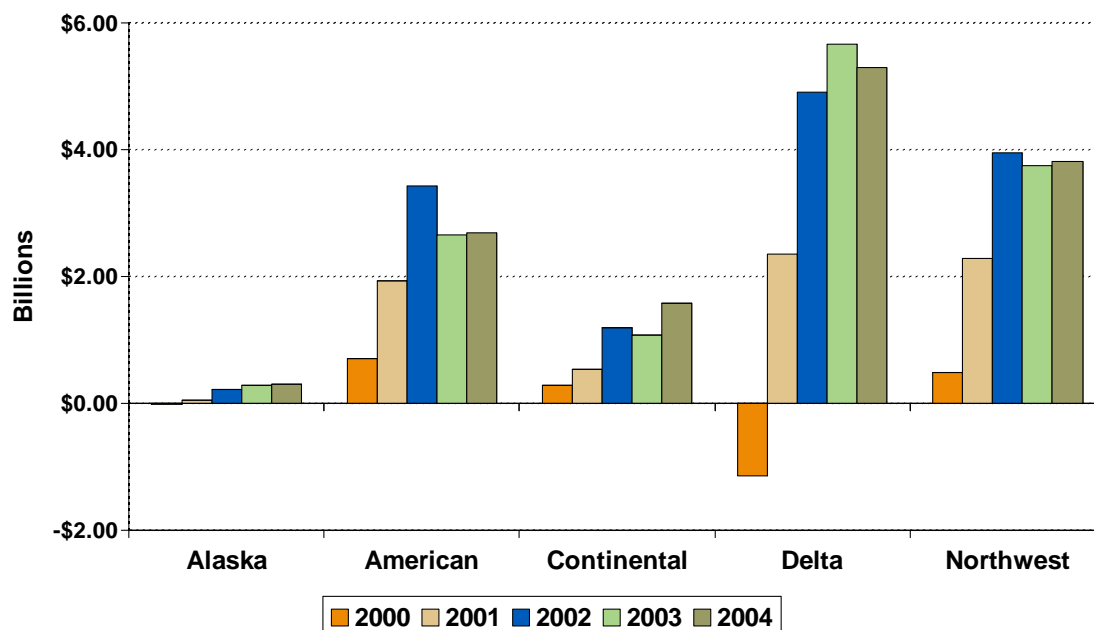
Now, having said all this, the current situation facing the US airline industry is not all bad. Indeed, in stark contrast to the legacy carriers, the financial performance of the LCCs has been remarkable. They are, as a group, consistently profitable and growing. In fact, neither Southwest nor jetBlue has had an unprofitable quarter since September 11, 2001, certainly a significant achievement for the most challenging four years in the history of the industry. And importantly, the success of the LCCs has helped create a low fare environment that has produced tremendous benefits to consumers. The question, then, is why has the financial performance of the legacy carriers differed so greatly from the LCCs?

I would submit to you that the deregulation of the industry that occurred in 1978 has finally “caught up” to the legacy carriers. We call them legacy carriers because they were each founded in the pre-1978 period, when both fares and routes were regulated by the Federal Government through the Civil Aeronautics Board (CAB). The cost structure of these airlines, even today, is to a significant extent a legacy of that regulated era. Under the regulatory system, the airlines were allowed to charge fares that generally reflected their costs, plus a modest profit. Thus they were able to offer lucrative pay and benefits packages, including pension plans and post retirement health insurance, because these costs could ultimately be built into the prices that were charged to consumers. Indeed, this system created an *disincentive* to cut costs, because profits were essentially calculated as a percentage of costs. The combination of this mechanism, and the regulatory limitation on the number of airlines allowed to serve a given route ensured the profitability of the industry.

Since deregulation, fares have on the whole declined, making it more difficult for the legacy carriers to operate profitably while maintaining these expensive benefits. And the events of the last four years have produced an environment in which prices are so low as to make these costs unsustainable for the legacy carriers.

The remaining legacy carrier pension plans are now underfunded by over \$14 billion, and as a result of the aging workforce and rapidly increasing healthcare costs, post retirement insurance plans were underfunded by nearly \$10 billion by the end of 2004.

Unfunded Status of Selected Major Airline Pension Funds Year End FY2004



Source: Airline annual reports.

The LCCs by contrast, can be thought of as essentially “post deregulation carriers.” They have, by and large, been founded after the deregulation of the industry in 1978.¹ As such, they have been designed from the ground up to be profitable in an environment of intense route and fare competition. Importantly, the business model of the LCCs is predicated on the primary objective of providing the lowest fares possible. The low cost structure in turn simply reflects that imperative. LCC wages generally remain below those of the legacy carriers, even despite the significant reductions made in the last few years. While all legacy carriers have historically offered pension and post retirement insurance benefits, no LCC has ever offered these benefits. LCCs have instead provided defined contribution and profit sharing plans that have a much lower overall cost to the airline.

LCC costs are also lower for a variety of other reasons. Though LCCs do provide connecting services, their operating model is based primarily on point-to-point services rather than a hub and spoke network. This allows higher asset utilization. Fewer flight crews are required per airplane, and fewer airplanes are required per scheduled departure. LCCs typically operate a single aircraft type, or very few aircraft types, which reduces training and maintenance costs, and allows crews to be more easily and cheaply interchanged. Southwest Airlines

¹ Southwest Airlines was founded in 1971, but provided only service within Texas before deregulation.

does not assign seats, allowing aircraft to be boarded more quickly, which in turn facilitates rapid aircraft turnaround times. The deregulation of route competition has also made it possible for LCCs to serve major metropolitan areas through secondary airports, which often have lower fees and charges than the primary airports most often used by the legacy carriers.

It is these structurally lower operating costs, combined with a greater ability to hedge against the dramatic increase in fuel prices, that have allowed the LCCs to remain profitable despite the otherwise difficult market environment. While the legacy carriers have traditionally made their money by charging very high fares to business travelers, the events of the last four years have fundamentally and perhaps permanently changed the market for air travel in the US. Travel has now exceeded pre 9/11 levels, but it is because fares are now so much lower. In this environment of lower fares, the average traveler is now much more price sensitive. The much flatter pricing structure of the LCCs is ideally suited to this environment, while the traditional pricing model of the legacy carriers has proven very difficult to sustain.

Impact of the recent bankruptcies

Perhaps the most obvious proof of this has been the recent bankruptcies of Delta Air Lines and Northwest Airlines. I'd like to now turn to the question of what these developments are likely to mean for the industry. First, some context. It is important to note that, notwithstanding the unprecedented financial challenges of the last four years, airline bankruptcies are not unusual in the post-deregulation era. In fact the US airline industry has seen nearly 150 bankruptcy filings in the last 25 years, an average of almost six per year. Though most of these companies were small regional carriers, there have also been a number of major airline bankruptcies, with most occurring during or just after significant downturns in the industry or the economy, as in the early 1980s, the early 1990s, and of course more recently since 9/11.

The most recent bankruptcies of Delta and Northwest, when taken together with the earlier bankruptcies of United, US Airways, and ATA however, represent an unprecedented level of financial failure in the industry. These carriers together represent nearly half the capacity in the industry.

Delta and Northwest will need to achieve something similar to a low cost carrier cost structure in order to survive. Labor costs will need to be reduced and work rules relaxed in order to increase labor and aircraft productivity. I believe the pension plans of both airlines are likely to be eliminated and replaced with much less costly defined contribution plans, in order to achieve a competitive cost structure for the long term. Consideration of proposed pension reform legislation should therefore have as its objective the preservation of some level of benefits for existing plan participants, rather than the provision of pension benefits for future workers.

Though the financial condition of both Delta and Northwest had been quite serious even before the most recent increases in fuel prices, it was the increased fuel prices that finally pushed them into bankruptcy. The proposed fuel tax holiday would save the industry about \$600 million. Though fuel tax relief probably would not have prevented the financial collapse

of these airlines, one lesson that can be learned from these bankruptcies is that the legacy carriers must seek to reduce costs wherever possible in order to survive. Taxes and fees now make up a much larger share of ticket prices than they did just four years ago. In the current low fare environment of very cost conscious travelers, the airlines are unable to pass these taxes and fees on to their customers, leaving less revenue available to contribute to profitability.

Consideration of the proposed fuel tax holiday should be viewed in this context, but at the same time, it's also important that it be viewed within the broader context of FAA funding requirements. Every dollar saved by the airlines from elimination of fuel taxes will be one less dollar available to fund nation's critical Air Traffic Control infrastructure needs. The FAA is already facing a potential funding shortfall, and Congress may eventually be asked to consider alternatives to the current funding mechanism. Reducing the amount of FAA funding derived from general revenues, or increases in the fees or taxes charged to the airlines to make up for any funding shortfall will only worsen the tenuous financial condition of the legacy carriers.

Outlook for the future

The recent bankruptcies also raise the question of what will happen to those legacy airlines that have managed to avoid bankruptcy so far. American Airlines achieved significant wage and benefit concessions from its unions early on in the crisis. Continental's losses were less severe than other legacy majors in 2004, and a modest profit the prior year helped it avoid a significant cash drain. Continental also does not provide post retirement insurance benefits. If Delta and Northwest's pension plans are terminated during bankruptcy, I think it's likely that American and Continental will eventually have no choice but to do the same. Given American's prior success at achieving labor concessions, and Continental's reputation for good labor relations generally, I'm optimistic that these airlines will be able to achieve the cost reductions necessary to continue to avoid bankruptcy in the near term. They, along with all the other legacy carriers will remain vulnerable to continued high fuel prices, however, as they will have no hedges remaining by the end of the year.

While the cost model of the legacy carriers will need to be transformed to more closely resemble that of the LCCs, the legacy carrier *operating* model is likely to remain. Though the hub and spoke system does not allow the high rates of asset utilization possible with point to point service, it provides many important benefits. Hubs create an economy of density that is in itself inherently efficient, providing the ability to connect far more cities using a given number of flights or aircraft. The number of international gateways is of necessity limited, and those hubs that form such gateways also represent an essential means by which to connect the domestic network with international destinations. Hubs are also essential for connecting smaller communities to the national air transportation network, as many of these communities could not otherwise support air service to many destinations.

If the legacy carriers can achieve sufficient cost reductions, they have several strategic advantages that will help them compete with the LCCs. They provide national networks connecting far more cities with higher frequency service than is possible with a point to point

operation, and they provide international services not presently offered by any LCC. Through alliances and marketing partnerships they offer coordinated connections to a global network with interchangeable frequent flyer benefits.

The US Airways/America West merger will provide an important test case. The two carriers seem to be a good strategic fit. US Airways is an East Coast focused airline while America West is a West coast focused airline. The combination will allow the creation of a larger national network facilitating more transcontinental service, and providing connections from the West Coast to US Airways Caribbean transatlantic and international services. America West essentially reinvented itself as a low cost carrier some time ago, and the challenge will be in producing this same type of transformation within US Airways. The lack of overlap between the two networks, however, will limit the ability of the merged entity to make capacity reductions that will improve systemwide yields.

Notwithstanding their current success, the Low Cost Carriers are themselves quite vulnerable. Were it not for the extensive fuel hedging undertaken by Southwest Airlines this year, they would be losing money at today's oil prices. The high cost of the portion of their fuel not presently hedged is reducing the profits the airline is now enjoying, and the extent of their hedging will decrease significantly over the next few years. And the other LCCs have much less hedging in place, leaving them even more vulnerable to continued high fuel costs. LCC labor costs are likely to increase over time, further putting pressure on their profitability.

But despite all of the challenges now facing this industry, the long term outlook remains very positive. None of the primary forecasters of air travel (Boeing, Airbus, FAA), revised their forecasts downward after 9/11. Air travel demand, both in the US and internationally is projected to grow rapidly. It is forecast to grow most rapidly in the Asia/Pacific region, where both United and Northwest have a significant market presence. New aircraft now in development, specifically the Boeing 787 and the Airbus A350, promise dramatic increases in fuel efficiency. The industry has already made great strides toward restructuring, and the LCC business model has proved robust in a most difficult market environment. While many challenges lie ahead, the industry that is likely to emerge from the current crisis will be more efficient, more productive, and more competitive in the global aviation market, and will remain a vital part of the nation's economy for years to come.

Mr. Chairman and members of the subcommittee, I thank you again for allowing me to appear before you today.

The US Airline Industry: Current Situation and Outlook for the Future



**Before the Aviation Subcommittee of the
Committee on Transportation and Infrastructure**

September 28, 2005

The current situation

- **\$32 billion in losses since 2000; expected to reach \$40 billion by year end**
 - Steep declines in stock prices have wiped out over \$24 billion market value
 - 5 of the 10 largest airlines have entered Chapter 11
- **Over 100,000 jobs lost since 2000**
 - Both Delta and Northwest have announced additional layoffs
 - Pay and benefits have been cut substantially
 - Largest pension default in US history
 - Remaining airlines have unfunded pension liabilities of \$14 billion
- **Effects of the crisis felt in many other sectors of the economy**
 - Aircraft financiers
 - Aircraft manufacturers and parts suppliers
 - Drop in funding for FAA and supporting infrastructure
- **Not all bad news**
 - Low Cost Carriers (LCCs) are profitable and growing
 - Southwest - 57 consecutive quarterly profits; JetBlue - 18 consecutive quarterly profits
 - Low fare environment has produced tremendous benefits for consumers



How we got here

- **Business travel has undergone a fundamental reorientation**
 - By 2000, weakening economy had already begun to dampen demand
 - And travelers were becoming increasingly intolerant of expensive unrestricted tickets
 - Disproportionate drop in business travel after 9/11
 - Now much more cost consciousness among business travelers
- **Unprecedented challenges have buffeted the industry since 2000**
 - Economic slowdown
 - War in Iraq
 - Events of 9/11
 - Dramatic increase in fuel prices
 - SARS
- **Advances in technology have reshaped the demand for travel**
 - Improved electronic conferencing facilities reducing need to travel
 - Penetration of online ticket sales has created unprecedented price transparency

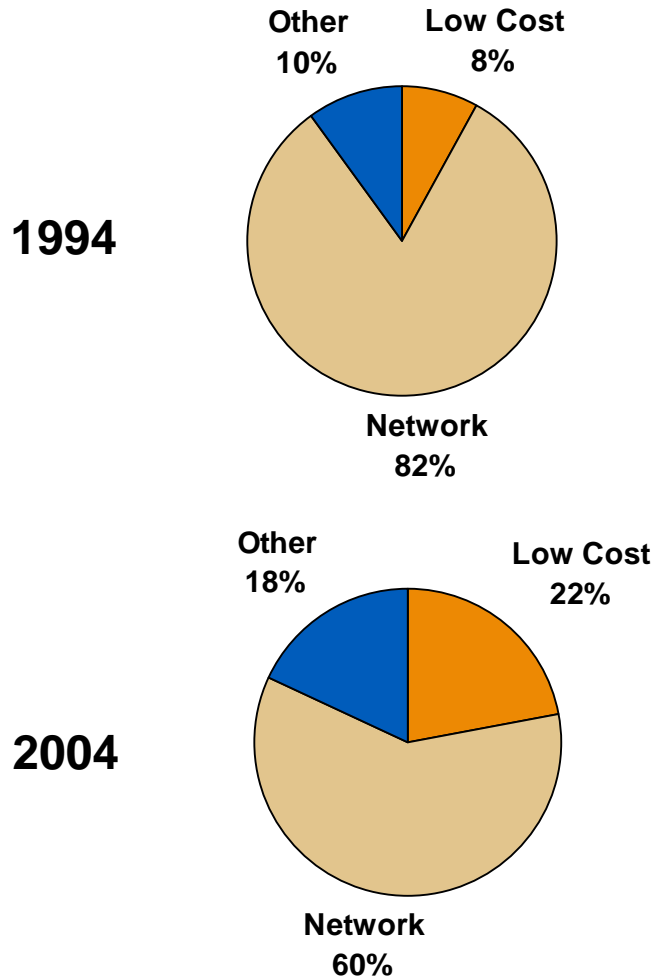
Low fares are not the exception, but the rule



INTERNATIONAL

Low Cost Carriers are now an integral and significant part of the industry

Airline Market Share by Category

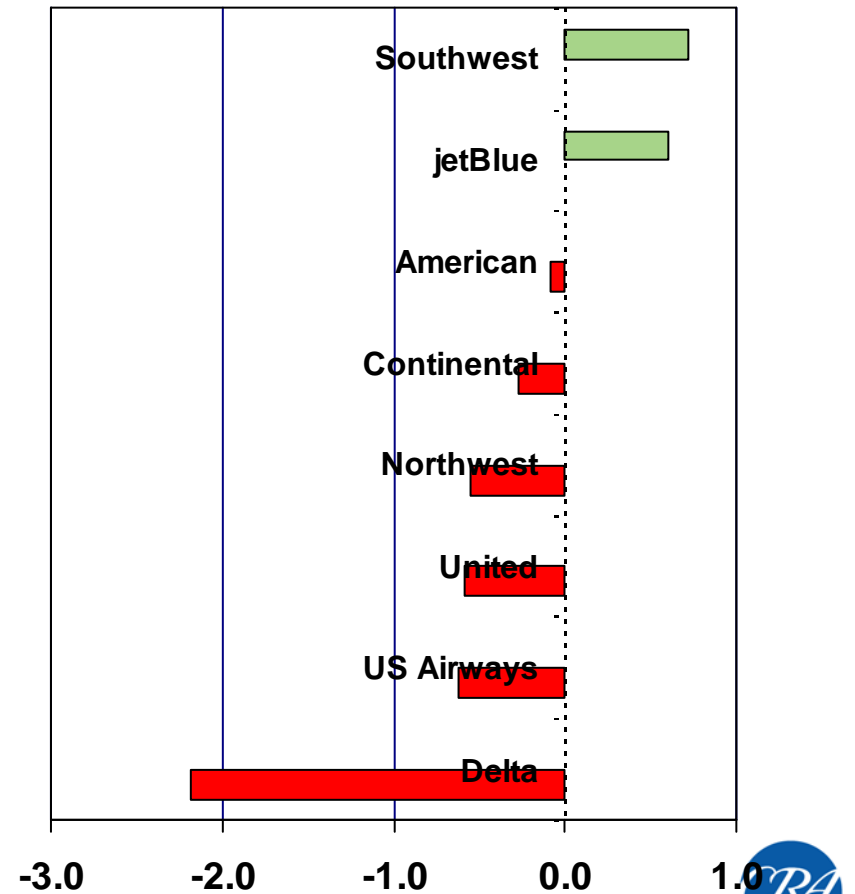


- Southwest Airlines is the largest domestic US airline
- jetBlue and AirTran are major carriers (>\$1 billion in revenue)
- Most cities served by legacy carriers are served by at least one LCC
- And legacy carriers face LCC competition in most city pair markets

Since 2001, the legacy network carriers have remained unprofitable, while LCCs are making money

- Significant market penetration means LCCs now dictate pricing
- LCC business model predicated on low fares
- At low LCC prices, legacy carriers can't make money

**Operating Margin for Selected US Airlines
for year ending 12/31/04**
(cents per available seat mile)



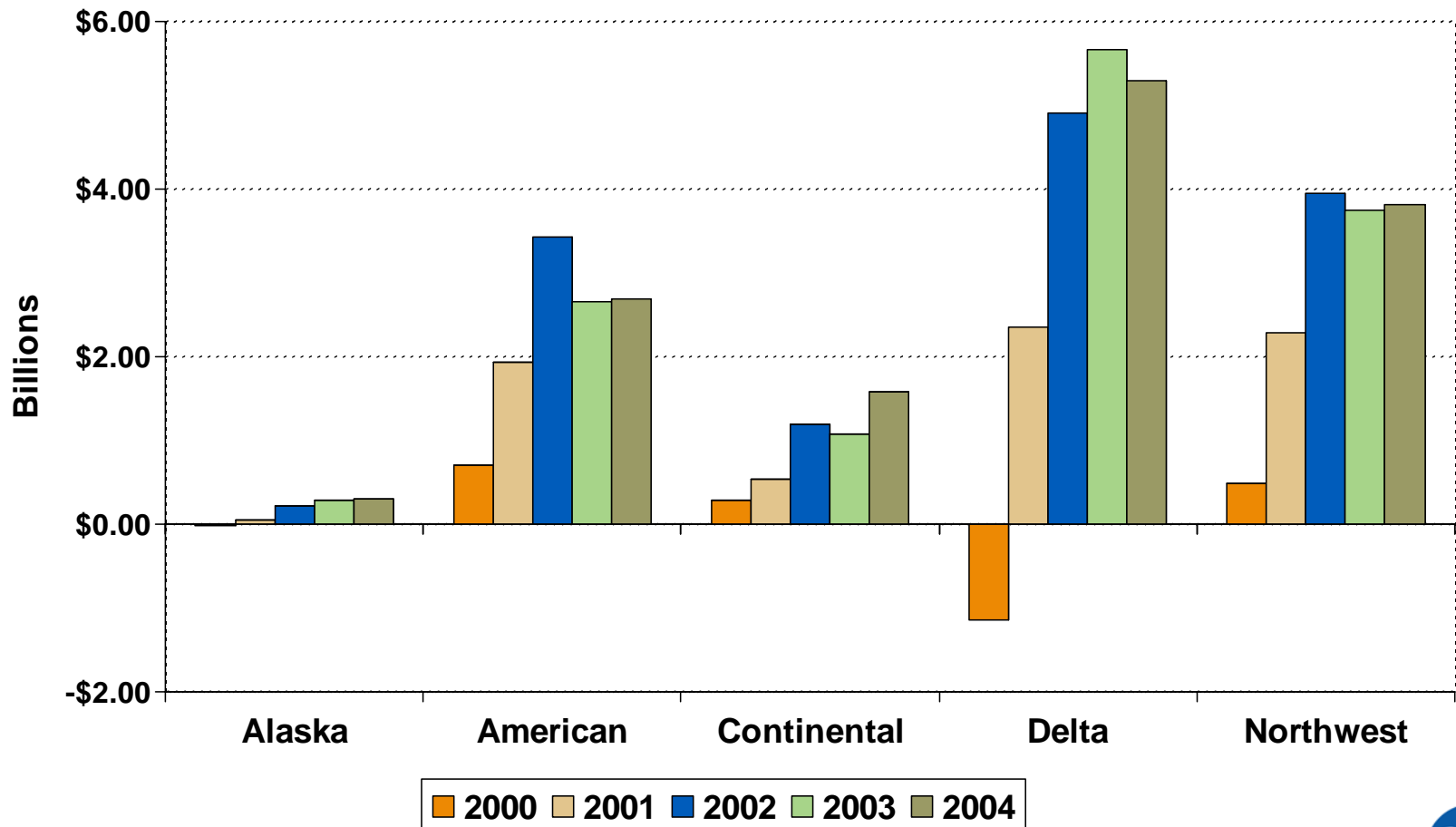
Deregulation has finally “caught up” with the legacy carriers

- **Legacy carrier cost structure a remnant of the regulated era**
 - Prior to 1978, routes and fares regulated by Civil Aeronautics Board
 - Cost increases could be passed on to customers through higher fares
 - Made possible high wages and lucrative benefits such as pension plans
- **Until recently, legacy carriers faced only limited price and route competition on a national scale**
 - Legacy carriers competed mostly with other legacy carriers
 - Hub dominance and limited competition for nonstop service a feature of hub and spoke networks
- **In current market environment, high labor costs have become unsustainable**



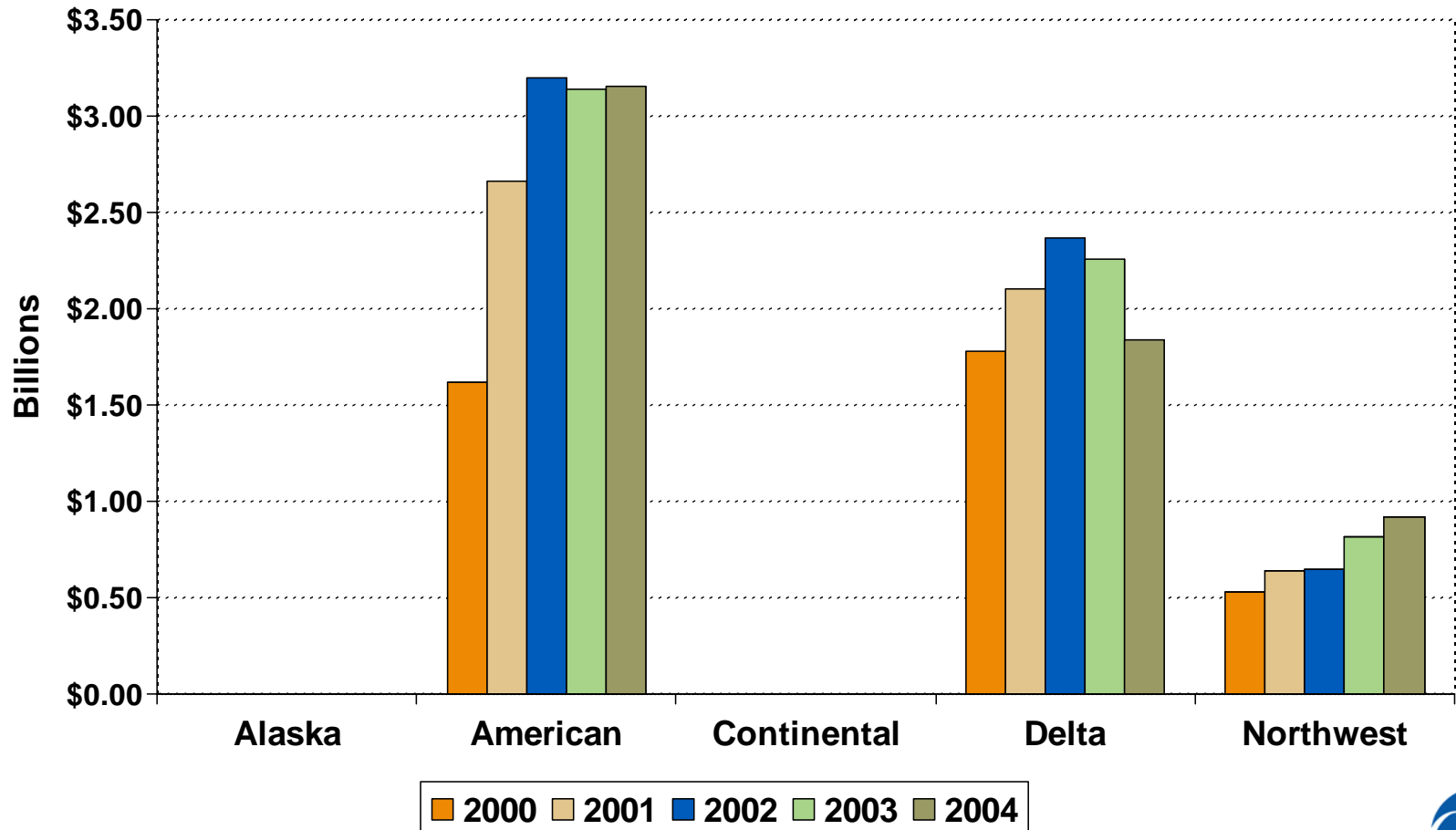
Unfunded pension liabilities have grown markedly for legacy carriers since 2000 ...

Unfunded Status of Selected Major Airline Pension Funds
(year end FY2004)



... and rising healthcare costs have produced large unfunded post retirement insurance liabilities

Unfunded Status of Selected Major Airline Post Retirement Benefits
(year end FY2004)



Low Cost Carriers are ostensibly “Post Deregulation Carriers”

- **Cost structure predicated on intense price competition (very low fares)**
 - Deregulation in 1978 provided for price and route competition
 - Advent of LCCs has generally occurred since then
- **Labor costs are structurally lower**
 - Wages have historically been much lower than legacy carriers; still lower in many cases
 - No LCC has ever had a pension plan or post retirement health insurance
 - Instead offer defined contribution plans and profit sharing
- **Operating model also designed to minimize costs**
 - Point-to-point operating model allows higher asset utilization
 - Single or few aircraft types reduces maintenance, training, and switching costs
 - Take advantage of route competition by flying to secondary airports



Impact of the recent bankruptcies

- **Airline bankruptcies common**
 - Over 150 bankruptcy filings in last 25 years
 - Significant number of major carriers
 - Most occurring around economic downturns
 - But carriers bankrupted since 2000 represent half of industry capacity
- **Delta and Northwest will need to achieve costs similar to LCCs**
 - Further wage reductions
 - Elimination of pension plans likely
- **Current proposals should be viewed in broader industry context**
 - Pension reform should focus on existing plan participants
 - Fuel tax holiday should consider FAA funding requirements
 - Any changes in FAA funding mechanism should consider the financial impact on the industry



Outlook for the future

- **Future of American and Continental uncertain**
 - Bankruptcy unlikely in the near term
 - If Delta and Northwest eliminate pensions, may have no choice but to follow
 - Labor relations may allow further successful negotiations of concessions
- **Legacy carrier operating model will remain**
 - Hub and spoke networks allow efficient connection of many cities
 - Important as international gateways
 - Essential for access to network by small communities
- **Despite current success, LCCs are vulnerable**
 - Labor costs will increase
 - Without hedges, Southwest would be unprofitable
- **Long term outlook remains very positive**
 - New aircraft promise dramatic increases in fuel efficiency
 - Significant growth in air travel forecast, particularly in Asia/Pacific region

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